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No. 79-1104

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

E.I. DU PONT DE NEMOURS & COMPANY,
Petitioner,

v.

THE UNITED STATES,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITIONER'S REPLY MEMORANDUM

DANIEL M. GRIBBON
Covington & Burling
888 Sixteenth Street, N.W.
Washington, D.C. 20006
Attorneys for Petitioner

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Respondent seeks to avoid review by suggesting that petitioner is undeserving because its foreign sales subsidiary lacks substance, by ignoring the long-standing practice of the Internal Revenue Service in the application of the controlling Treasury regulation and by urging that the decision of the Court of Claims cannot create a conflict because cases under Section 482 of the Internal Revenue Code are so marked by factual dissimilarities as not to present true legal issues. Respondent errs in each of these respects. More significantly, respondent does not deny the importance of this recurring issue to the administration of the tax laws, as demonstrated in the petition. Pet. 14-15. In addition, despite respondent's prof-

fered rationalizations, the approach and decisions of the lower federal courts on this issue remain in fundamental disarray clearly calling for review and supervision by this Court.

1. Respondent culls fragmented excerpts from the record in an effort to suggest that DISA is a paper company, with little or no business substance. Mem. in Opp. 2-4 & nn. 1, 4. Respondent thereby seeks to justify its assertion that petitioner's relationship with DISA was so materially different from that between arms' length distributors and resellers as to render comparison meaningless. *Id.* at 4. The facts are to the contrary. The Court of Claims found that "DISA was created to serve legitimate commercial objectives," that it contributed significantly to petitioner's sales performance and that it performed tasks beyond the function and competence of normal resellers. 78-1 USTC ¶9374, at 83,945, 83,942-44. Thus, insofar as differences exist between DISA and arms' length distributors, they favor allocating higher profits to DISA. The issue here—truly one of law—is whether the court below was correct in determining that these differences warrant abandonment of the resale price method.

2. The differences between DISA and arms' length resellers are urged by respondent as justification for the failure of the Court of Claims to apply the resale price method specified in the regulations. Mem. in Opp. 4-5. Respondent, however, fails to acknowledge that the regulation specifically requires use of that method, notwithstanding significant differences, including differences as to products sold and geographical area served. Treas. Reg. § 1.482-2(e)(3)(vi) and (vii). In addition, both the regulation and the IRS Manual expressly contemplate reference to the IRS Source Book of Statistics of Income in the application of the resale price method. Treas. Reg. § 1.482-2(e)(3)(vii); I.R.M. 623.8(4); 623.9(2) Ex. 600-3; B.5.b. Indeed, since 1960, in allocating income from DISA to petitioner, the Service has consistently looked to the experience of wholesale chemical companies as reported in the Source Book, relying, however, upon net

margins rather than gross margins as specified in the controlling regulation. Treas. Reg. § 1.482-2(e)(3)(vi). When the resale price method is properly applied, using the Source Book data for chemical wholesale companies, DISA's profits fall comfortably within the range of gross margins of such companies and no allocation is required.

The refusal of the Court of Claims, which is wholly ignored by respondent, to hold the government to an interpretation of the regulation long and consistently applied by the Service, tolerates and encourages arbitrary application of the tax laws.

3. Respondent does not dispute the importance and recurrence of the issue presented. Pet. 14-15. Nor is there any disagreement that the issue is of major importance in the administration of the tax laws, and that the present case has been chosen by the Internal Revenue Service as a test case. Pet. 15. Rather, respondent's opposition rests on the premise that Section 482 cases are heavily fact oriented and the questionable conclusion that, consequently, no conflict exists—or presumably can ever exist—in this area. Mem. in Opp. 7-9. However, as with so many other areas of the law, the factual context in which Section 482 is applied does not relieve the courts of the need to distill and apply legal principles in deciding the cases before them.

Contrary to respondent's assertion, a clear and definable divergence does exist between the analysis of the opinion below and that of other courts. Thus, in *United States Gypsum Co.* v. *United States,* 452 F.2d 445 (7th Cir. 1971), the court upheld the intercompany rates set by the taxpayer, even though it found that the transaction had no real-world analogue. While dealing with other, inapposite, aspects of the case, respondent fails to mention this key point. Similarly, respondent does not acknowledge that in *Cadillac Textiles Inc.,* 34 TCM 295 (1975), in reversing the Service's allocation, the Tax Court recognized the unique relationship between parent and subsidiary, including the fact (emphasized by the Court of Claims in this case) that the subsidiary was insulated from some market

risk by being assured of the parent's continuing business. *Id.* at 305-06. *PPG Industries, Inc.*, 55 T.C. 928 (1970) and *Ross Glove Co.*, 60 T.C. 569 (1973) are not to be dismissed as respondent would have it, as simply "turn[ing] on their particular facts." Mem. in Opp. 8. In *PPG* the Tax Court rejected the Service's allocation and, by reference to industry-wide statistics, allowed a foreign selling company half of the total profits (approximately the portion claimed for DISA). In *Ross Glove* the court considered industry-wide markup percentages adopted by the Customs Bureau. *See also, Baldwin-Lima-Hamilton Corp.* v. *United States,* 435 F.2d 182, 186 (7th Cir. 1970), a case which respondent does not attempt to distinguish. In each of these cases the courts placed heavy reliance on industry-wide statistics. Here, by contrast, the Court of Claims dismissed as irrelevant the Source Book of Income Statistics, despite the Service's long-standing use of such data in reallocating income to petitioner and other taxpayers under Section 482.

Respondent's attempt to characterize an important legal issue as merely a factual dispute should not divert attention from the fundamental question here presented. That is whether the Commissioner is to be allowed to resort to his "general discretion," Pet. App. A-23, rather than being required to adhere to the applicable Treasury Regulations in reallocating income between parent and subsidiary, simply because, by its very nature, the parent-subsidiary relationship cannot be precisely duplicated in arms' length transactions. *See,* Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code,* 89 Harv. L. Rev. 1202, 1214-23 (1976). As noted in the petition, and not disputed in the response, the Service is currently in the process of conducting Section 482 reallocations involving hundreds of millions of dollars of income. Pet. 14 & n.17. Marked differences

of approach have emerged among the lower federal courts in reviewing these reallocations. This Court should resolve those differences and clarify the application of this important provision of the Internal Revenue Code.

Respectfully submitted,

DANIEL M. GRIBBON
Covington & Burling
888 Sixteenth Street, N.W.
Washington, D.C. 20006

Attorneys for Petitioner

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